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No. 482

In the Supreme Court of the United States

OCTOBER TERM, 1960

TENNESSEE LIFE INSURANCE COMPANY, PETITIONER

v.

E. L. PHINNEY, DISTRICT DIRECTOR OF INTERNAL REVENUE AT AUSTIN, TEXAS

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The District Court entered findings of fact and conclusions of law (R. 52–60).[1] The orginal opinion of the Court of Appeals (Pet. 27–37) and the *per curiam* opinion denying the taxpayer's petition for rehearing (Pet. 39) are not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on June 13, 1960 (Pet. 38). The order of the Court

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[1] Record references are to the separately printed record in the Court of Appeals.

of Appeals denying the taxpayer's petition for rehearing was entered on July 15, 1960 (Pet. 39). The petition for a writ of certiorari was filed on October 12, 1960. The jurisdiction of this Court is involved under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, in order to reflect clearly the true income of each organization, the Commissioner was authorized under Section 45 of the Internal Revenue Code of 1939 to allocate a deduction for *ad valorem* real estate taxes for the year 1953 between two organizations, both of which were owned and controlled by the same interests, in proportions that corresponded to the period of time each held title to the property during the year 1953.

STATUTE AND REGULATIONS INVOLVED

Section 45 of the Internal Revenue Code of 1939 provides:

> SEC. 45 [as amended by Sec. 128(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21]. ALLOCATION OF INCOME AND DEDUCTIONS.
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, ap-

portionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. (26 U.S.C. 1952 ed., 45.)

Also involved is Section 39.45–1 of Treasury Regulations 118, the pertinent parts of which are set forth in the Appendix, *infra*, pp. 15–18.

STATEMENT.

The facts, stipulated in large part (R. 25–46) and as found by the District Court (R. 52–59), may be summarized as follows:

This suit was instituted by Tennessee Life Insurance Company (hereinafter called the "Life Company") as transferee of Tennessee Gas Building Corporation (hereinafter called "Building Corporation") to recover taxes paid on behalf of Building Corporation for the calendar year 1952 (R. 52–53). The suit is based upon a claim that Building Corporation sustained a net operating loss in 1953 which may be carried back and deducted in 1952 (R. 59). Whether this net operating loss was sustained depends primarily upon whether Building Corporation, which transferred the property involved on January 19, 1953, and was dissolved on January 23, 1953, was entitled to take a deduction for the amount of *ad valorem* taxes assessed against the property for the entire year 1953. (See R. 3–4, 57–58.)

Building Corporation was organized for the purpose of owning and operating the Commerce Building in Houston, Texas (R. 53). Throughout its exist-

ence it maintained its books of account and reported its taxable income on the accrual basis of accounting (R. 54). During each of its taxable years 1951 and 1952 it made monthly entries on its books of account for the *pro rata* estimated expenses for *ad valorem* taxes of each such monthly period. It prepared monthly statements of profit and loss, reflecting the entries made to its books of account, but did not publish or communicate these to any third party (R. 55).

Building Corporation and Life Company were both wholly owned subsidiaries of Tennessee Gas Transmission Corporation, which, on January 19, 1953, transferred all of the outstanding capital stock of Building Corporation to Life Company as a contribution to the capital of Life Company. On the same day, Building Corporation adopted a plan of complete liquidation and dissolution under which, on that date, it transferred all of its assets (including the Commerce Building), subject to its liabilities, to Life Company. Building Corporation was formally dissolved on January 23, 1953 (R. 56).

On January 19, 1953, just prior to its dissolution, Building Corporation entered on its books of account, as an estimated liability, the amount of $152,340 for *ad valorem* taxes for the calendar year 1953 on the Commerce Building and other properties which it held on January 1, 1953. In Texas real property is assessed as of January 1. The actual assessments of the taxes here involved, which were entered on the tax rolls by the appropriate officials subsequent to January 23, 1953, were in the amount of $143,570 and were not paid by Building Corporation (R. 56–57).

In its income tax return for the period January 1 to January 23, 1953 (hereinafter called the short year 1953), Building Corporation reported the rentals paid by Commerce Building tenants for the whole month of January, 1953, and claimed a deduction for *ad valorem* taxes for the entire calendar year 1953, in the amount of $143,570. The result, principally due to the deduction for *ad valorem* taxes, was a net operating loss which, in its 1952 tax return, Building Corporation sought to carry back and deduct against its income for that year (R. 57–58, 59).

Being of the view that Building Corporation's tax return for the short year 1953 did not truly reflect its taxable income for that period, the Commissioner adjusted the return so as to include only 18/31sts of the rentals in income and to allow a deduction for *ad valorem* taxes in the amount of only $7,080, which represented 18/365ths of the total taxes for the entire year or, in other words, the pro rata part for the 18-day period in 1953 prior to the transfer of the properties by Building Corporation to Life Company. As so adjusted, Building Company's return for the short year 1953 did not show a net operating loss (R. 58).

The District Court sustained the Commissioner's determination that these adjustments were necessary to reflect clearly Building Corporation's income for its short year 1953 (R. 58–59) and accordingly rejected Life Company's claim to a refund of taxes as transferee of Building Corporation (R. 59–60). The Court of Appeals, with one judge dissenting, affirmed the District Court (Pet. 27–37), holding not only that

the Commissioner had authority to make the adjustments on Building Corporation's return in order to reflect its true taxable income, but that in any event the *ad valorem* taxes had not accrued prior to the transfer of the properties by Building Corporation except to the extent that such taxes were allocable over the year by months under the usual method of accounting used by Building Corporation.

ARGUMENT

Among the grounds urged by the taxpayer in support of its petition are that the decision below is in conflict with the decisions of this Court in *Magruder* v. *Supplee*, 316 U.S. 394, and of the Sixth Circuit in *Simon J. Murphy Co.* v. *Commissioner*, 231 F. 2d 639. In our view the conflict with the decision of this Court does not exist and the conflict with the decision of the Sixth Circuit does not present a question of sufficient importance to require review of the case by this Court.

1. The taxpayer is in error in asserting (Pet. 9, 13–14) that the decision below is in conflict with *Magruder* v. *Supplee*, 316 U.S. 394. In that case the question was whether the vendee of property was entitled to a deduction, as a "tax paid," for its payment of state and city real estate taxes on the property which it had purchased. The answer depended, as the Court stated, on whether the taxes were imposed on the vendor or the vendee. Since the taxes had been assessed and had become due and payable prior to the sale of the property, from which it followed that the taxes had become a lien on the property

and that the vendor had become personally liable for their payment, the Court denied the claimed deduction on the ground that, in paying the taxes, the vendee had not discharged a liability imposed upon it, but had instead simply made an additional payment of purchase price by contractual arrangement with the vendor. Regardless of what pertinence that holding may otherwise have here—where the transfer, instead of being by way of a sale, was from one controlled corporation to another in a corporate liquidation—the question differs because of the addition of the element of the Commissioner's power under Section 45 of the Internal Revenue Code of 1939, *supra*, pp. 2–3, which specifically relates to controlled corporations. The court below held (Pet. 35–36) that this section authorized the Commissioner to allocate the Texas real property taxes involved here as between the taxpayer and its transferee, both of which were controlled corporations. As the court properly stated (Pet. 36), "There is nothing in the *Magruder* v. *Supplee* case that is inconsistent with this holding."

2. The taxpayer asserts that the decision below is in conflict with *Simon J. Murphy Co.* v. *Commissioner*, 231 F. 2d 639 (C.A. 6), "on two broad fronts." (Pet. 10.) One relates to the time when real property taxes should be accrued and therefore by whom they may be deducted on a sale of the property between unrelated taxpayers—a point on which *Murphy* held that, for 1950 Michigan real property taxes, accrual is proper as of January 1, 1950, and the court below

held that for Texas real property taxes a ratable accrual over the year is proper. Whether these holdings are in conflict in respect of the normal accrual time for real property taxes does not control here. The result reached by the court below is correct, regardless of the proper treatment of taxes in case of a sale between arms-length participants, if, under its "broader" basis for decision (Pet. 35), the court below was correct in holding that the Commissioner had power under Section 45 to allocate the Texas real property taxes between the two controlled corporations, the taxpayer and its transferee.

On this latter question, however, the decision below is admittedly in square conflict with *Murphy*. The Sixth Circuit held that the Commissioner's power of allocation under Section 45 in relation to corporations under common control is exercisable only when there is a showing of improper manipulation of income or deductions—that is, "collusive or improper conduct" (p. 645)—as between the controlled corporations. In contrast, the court below refused to restrict the Commissioner's power under the statute, holding (Pet. 35) that it "permits the Commissioner to deny to one of two related taxpayers such part of a deduction as is necessary to prevent the true taxable income to be distorted * * *".

3. Despite the conflict between the decision below and *Murphy* as to the scope of the Commissioner's power under Section 45, we submit, that, though the question is important, the nature of the conflict is not such as to require resolution by this Court.

(a) The decision below is correct and in accord with the weight of authority, whereas *Murphy* is an isolated decision. Section 45 does indeed give the Commissioner power to allocate income and deductions where there is "collusive or improper conduct," which *Murphy* concedes, but the court was incorrect in holding in *Murphy* (p. 645) that such conduct "is necessary" to permit the Commissioner to make an allocation under Section 45. Such a holding has the effect of restricting the Commissioner's power under the statute to making allocations which are necessary to prevent tax evasion, whereas the statute expressly confers the power of allocation where it "is necessary in order to prevent evasion of taxes *or clearly to reflect the income* of any of such [controlled] organizations * * *" (italics supplied). The Second Circuit has expressly stated that the power of allocation to reflect clearly income is "an independent reason for reallocation," that it "has been traditionally cited as such", and that the lower court's "assumption of the necessity of finding some ulterior motivation * * * was error." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 215–216, certiorari denied, 344 U.S. 874. This is the rule which the court below obviously applied in the present case, as in prior cases.[2] It is a rule which other courts, in addition to the Second and Fifth Circuits, have implicitly applied

[2] *Jud Plumbing & Heating* v. *Commissioner*, 153 F. 2d 681 (C.A. 5); *Grenada Industries* v. *Commissioner*, 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819; *Willard-Waltermire, Inc.* v. *Campbell*, 255 F. 2d 433 (C.A. 5).

and, indeed, on occasion without expressly mentioning Section 45. See, e.g., *National Securities Corp.* v. *Commissioner*, 137 F. 2d 600 (C.A. 3), certiorari denied, 320 U.S. 794; *G. U. R. Co.* v. *Commissioner*, 117 F. 2d 187 (C.A. 7); *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330 (C.A. 10), certiorari denied, 342 U.S. 860. And, in fact, the right to reallocate income between controlled corporations even in the absence of improper conduct is clearly reflected in Treasury Regulations 118, Section 39.45–1, ¶(c), *infra*, pp. 17–18, in the provision that "the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits or allowances."

The taxpayer is not correct in asserting (Pet. 9, 14–16) that the decision below abrogates what it calls the "arm's length standard" prescribed in Treasury Regulations in relation to the application of Section 45. Although the taxpayer correctly quotes (Pet. 15) the Regulations, *infra*, pp. 15–18, the standard cannot properly be applied to give to related enterprises a tax treatment which would be accorded to independent entities dealing at arms length when the nature of the transaction is one peculiar to related corporations so that there is in fact no comparable factual situation between related corporations. In the present case, permitting the taxes for the entire year to be deducted by the Building Corporation would not place it and the Life Company in the same position as

unrelated taxpayers; on the contrary it would treat a coalescing of corporate enterprises through the medium of transfer of assets and liquidation as though it were an ordinary sale, and the parties thereto as though they were a vendor and vendee. Here the transfer of property occurred in connection with a liquidation, and thus was a transfer which could not take place between unrelated taxpayers. The result, if the taxpayer is allowed a deduction against its January 1953 income for the full year's real estate taxes, is that the taxpayer's net income is so distorted that it has a net loss for its short year 1953 when even under its own prior accounting practice it had taxable income. The justification for an allocation of the deduction for real estate taxes is that no such transfer or distortion of true income could result in a transaction between unrelated taxpayers. In the case of a sale of property the real property taxes would normally, if paid by the purchaser, be treated as an addition to the purchase price and there would in any event be income against which the deduction for real estate taxes would be offset.[3]

(b) The conflict between *Murphy* and the decision below in relation to the scope of the Commissioner's power under Section 45, although fundamental, should not require action by this Court. Many of the cases

[3] The Sixth Circuit failed to recognize this in *Murphy*. In fact, it apparently viewed (p. 645) the situation in the case of a liquidation as being no different, from a tax standpoint, than if the liquidating transferor sold the property to an unrelated taxpayer for cash and then used the cash to purchase its own stock.

applying Section 45 have involved situations where there was improper conduct on the part of the controlled corporations, and of course cases of that type are unaffected by the limitation which *Murphy* put on the Commissioner's power under Section 45. Thus, the conflict between *Murphy* and the decision below has a bearing only on those cases where there is a distortion of true income even in the absence of collusive or improper conduct, as may be the case on the liquidation of a controlled corporation. In the past relatively few such cases have given trouble. Since the decision below is supported by the weight of authority, it seems unlikely that *Murphy* will be followed by other courts, and in that circuit perhaps only in relation to accrual of real estate taxes, a question which will disappear under the present Internal Revenue Code. At any rate, there is at the present time no urgency for a review by this Court of the issue as to the scope of the Commissioner's power under Section 45; it appears that such review can await a further conflict with the decision below.

(c) On the narrower point of conflict between *Murphy* and the decision below—the application of Section 45 in relation to the deduction for real property taxes—the conflict will not be important for years subsequent to 1953.* Section 164(d) of the Internal Revenue Code of 1954 specifically provides for an

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*As to years prior to 1954, *Murphy* and the decision below appear to be the only cases in which the question of the Commissioner's power under Section 45 in relation to property taxes has arisen.

allocation of real property taxes as between the buyer and seller of property and Section 461(c)(1) permits an accrual basis taxpayer, at its election, to accrue such taxes ratably over the period of time to which they relate. These new Code provisions are consistent with the Commissioner's action in the present case. Section 461(c)(1) particularly, which of course, like Section 164(d), applies even to unrelated taxpayers, should eliminate any question of the propriety of a ratable allocation of real property taxes between controlled corporations—if, indeed, it ever becomes necessary for the Commissioner to make such an allocation under the 1954 Code.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

Treasury Regulations 118, promulgated under the Internal Revenue Code of 1939:

SEC. 39.45–1. *Determination of the taxable net income of a controlled taxpayer.*—(a) *Definitions.* When used in this section:

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations in this part), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The terms "trade" or "business" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations,

trades, or businesses owned or controlled by the same interests.

(6) The term "true net income" means, in the case of a controlled taxpayer, the net income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transallowances, resulting to the controlled taxpayer or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting net income, be-

tween or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 45 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate net income. If a controlled taxpayer is a party to a consolidated return, the true consolidated net income of the affiliated group and the true separate net income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 45 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Commissioner to apply such provisions. It is not intended (except in the case of the computation of consolidated net income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated net income under section 141.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Commissioner is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions,

credits, or allowances. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

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